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STATE FOR EAP/RSP/TC, EAP/EP

USTR FOR WINTER AND WINELAND

USDOC FOR 4420/USFCS/OCEA/EAP/LDROKER
USDOC FOR 3132/USFCS/OIO/EAP/ADAVENPORT
TREASURY FOR OASIA/LMOGHTADER
TREASURY PLEASE PASS TO OCC/AMCMAHON
TREASURY ALSO PASS TO FEDERAL RESERVE/BOARD OF
GOVERNORS, AND SAN FRANCISCO FRB/TERESA CURRAN

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SUBJECT: Economic Briefing for October 2005

REF:

1. This cable summarizes selected recent economic events in Taiwan in October 2005:

- Economic performance in Q3
- Office Space
- Capital outflow weakens NT Dollar
- Renminbi exchange liberalization
- PRC Tourists in Taiwan
- Semiconductor facility utilization
- Taiwan students consider China
- Hong Kong-Taichung charter flights
- ECCT Criticism
- Hurricane Katrina reconstruction

Taiwan Economic Performance Improves

2. Although production and trade growth remained at single-digit levels, Taiwan has seen solid signs of improvement in economic performance in Q3 this year. A decline in inventories in advanced-country markets and weaker NT dollar has contributed to a steady rise in Taiwan's export growth from 3.1% in June to 8.5% in September. Local economists expect the growth in exports will continue as the U.S. Government implements a US\$200 billion hurricane damage reconstruction program (see Para 12). Taiwan's manufacturing sector has gone from negative growth of 1% in Q1 to a 12-month high of 6.4% in September 2005. Foreign investment in Q3 shot up 53.6% from a year ago, a sharp contrast to the negative figures in Q1 and Q2. Higher oil prices, coupled with storm damage to vegetable and fruit farms this summer, pushed up the inflation rate to a nine-year high of 3.6% in August (it declined to 3.1% in September.) In late October, the Chunghua Institution for Economic Research forecast Taiwan's 2005 quarterly growth would rise from 2.5% in Q1 and 3% in Q2 to 4.1% in Q3 and 4.4% in Q4. It predicts that 2005 real GDP will grow at 3.5%.

Grade A Real Estate

3. The Taipei 101 Tower (the world's tallest building) and the Uni-President HQ Building both became available for occupancy in the second quarter of 2005 causing the vacancy rate of Taipei Grade A office space to jump from a little over 5% to almost 19%. Rents, which had risen in the three previous quarters, fell slightly in the third quarter.

Capital Outflow Weakens NTD

4. Taiwan's foreign exchange market has experienced huge fluctuations over the past year. Capital inflows from July 2004 to March 2005 caused the NT Dollar (NTD) to gain 10% against the US dollar (USD). However, from July through October this year large capital outflows have weakened the NTD by 9.35%. The inflows late last year and early this year were partially due to Morgan Stanley Capital International increasing Taiwan's weight in its stock price index and partially due to expectations for greater renminbi (RMB) appreciation (because most Taiwan investment is located in China.) The NTD went from NT\$34.2 per USD in July 2004 to a five-year high of NT\$30.8 per USD in March 2005.

5. The PRC permitted the RMB to appreciate only 2% in July this year, far less than the 10% predicted by many in the business community. Speculative capital flowed out of Taiwan after the failure to gain from a more significant RMB

appreciation. Some foreign portfolio investors also withdrew investment funds in reaction to Taiwan's political stalemate and corruption scandals. Taiwan's stock price index declined 10% from July to October, and the NTD depreciated to 33.7 per USD at the end of October 27.

RMB Exchange - Further Liberalization?

16. Taiwan's RMB-NTD direct currency exchange pilot program on the offshore islands of Kinmen and Matsu saw RMB 1.7 million exchanged from October 3 to 20. People First Party Legislator Christina Liu has introduced a bill that would remove the requirement for a bilateral exchange settlement agreement and require only an exchange settlement mechanism as a prerequisite for allowing direct RMB-NTD currency exchange throughout Taiwan. The bill is currently under review in the Legislative Yuan.

PRC Tourism Up for "Golden Week"

17. The Travel Agent Association of Taiwan (TAAT) told AIT that during September 28 - October 2 National Day holiday in China ("Golden Week") approximately 3,000 PRC tourists visited Taiwan. This was more than twice the number of visits in the entire month of October last year. TAAT estimated that each tourist spent an average of around USD 5,000 to visit Taiwan and that Taiwan businesses took in an additional NT\$300 million (about US\$9 million) as a result. Taiwan currently permits only PRC nationals who are living or traveling abroad to visit Taiwan for tourism.

Semiconductor Capacity Utilization

18. Taiwan Semiconductor Manufacturing Company (TSMC) announced that its capacity utilization rate increased from 78% in the first quarter to 96% in the third quarter. The firm predicts that utilization will rise further to over 100% in the fourth quarter. (Semiconductor manufacturing firms base capacity utilization rates on the standard specifications for manufacturing equipment. With modified equipment, capacity utilization rates can exceed 100%.) United Microelectronics Company (UMC), TSMC's main rival, reported that its capacity utilization rate increased from 63% in the first quarter to 78% in the third and should hit 85% in the fourth. TSMC and UMC are the world's two largest contract semiconductor manufacturers.

Taiwan Students Look West

19. According to a survey published by Taiwan's Career Media magazine, the PRC has surpassed the United Kingdom to become Taiwan students' second favorite destination for graduate studies after the United States. The survey indicated that the main reason Taiwan students are interested in studying in China is because they believe a degree from a PRC institution will help them get a job there. The magazine reports that there are approximately 10,000 Taiwan students in China's graduate and undergraduate programs. According to the survey, 60% of Taiwan undergraduates are willing to work in the PRC.

More Hong Kong-Taichung Charter Flights

110. Taichung Mayor Jason Hu visited Hong Kong October 14 urging Hong Kong authorities to resume charter flight service to Taichung. Hong Kong authorities approved an application from Taiwan's Mandarin Airlines on October 18 to conduct two round-trip charter flights on October 20 and 23. Even with such short notice, Mandarin Airlines was able to fly October 20 with a passenger load of 80% of capacity. UNI Airways Corp. was later approved for a Taichung-Hong Kong flight on October 27 and a Hong Kong-Taichung flight on October 29.

ECCT Has Harsh Criticism for Taiwan

111. The European Chamber of Commerce in Taipei (ECCT) released its 2005-2006 Position Papers at a press conference on October 26. The Position Paper warns that Taiwan is losing business competitiveness relative to other East Asian economies and cites four key areas where change is needed: 1) over-regulation, 2) slow cross-Strait commercial normalization, 3) WTO non-compliance, 4) slow services upgrade. Taiwan's Council for Economic Planning and Development has promised to hold meetings to discuss the ECCT proposals.

Hurricane Katrina Reconstruction Benefits Taiwan

12. The U.S. is implementing a US\$200 billion reconstruction program for three southern states that sustained heavy damage from Hurricane Katrina. The program has started to benefit Taiwan's export sector, particularly for furniture, fixtures, pipes & tubes, power tools, hand tools, and auto parts. For a number of Taiwan companies, export orders received in September and October shot up by 90% from a year ago. September 2005 sales of Chen Lin, a major faucet supplier, nearly doubled to NT\$400 million (US\$11.9 million). Taiwan suppliers expect that export orders from and sales in the three southern states will continue to increase through early next year.

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